RMA online

Tuesday, January 23, 2001

Futures Contracts

What is a Futures Contract?

A futures contract is a legally binding, standardized agreement between two parties to buy or sell a predetermined amount of a commodity, such as corn, during a specified month in the future (the delivery month) at a price (the futures price) which is determined at the time the contract is established. **This summary is for general illustrative purposes only.** Please contact a commodity broker of your choice for information specific to your operation.

Where Are Futures Contracts Traded?

Futures contracts (as well as options on futures contracts) are traded at 11 different commodity exchanges in the U.S. as well as abroad. Futures contracts on the major domestic agricultural crops are traded at the Chicago Board of Trade (CBOT), the Kansas City Board of Trade, the Minneapolis Grain Exchange, the New York Cotton Exchange and the Coffee, Sugar and Cocoa Exchange.

What Benefits Are Gained From Buying and Selling Futures Contracts?

One of the most important benefits gained from trading in the futures market is that traders can assume any of a wide range of commodities or other assets with a relatively small initial investment. The initial investment includes a commission of approximately $50 per contract and a margin. A margin is a good faith deposit. When a trader assumes a futures position, he or she locks in a price for future delivery for the underlying commodity. This fixed price is the futures price at which the contract is bought or sold. Subsequently, as the price of the actual commodity rises or falls, the futures price follows suit, making or losing money. A benefit derived from selling futures contracts is that it enables the trader to establish, in advance, an approximate price for crops he or she intends to harvest and market at some future time. This provides protection against dangerous price swings, and enables speculators to profit from market fluctuations. Speculators are market participants who have no intention, or interest, in owning or selling a physical commodity, but have the money to take on risk -- buying and selling futures contracts in hopes of making a profit.

What is a Hedge?

A hedge is the buying or selling of a futures contract for protection against the possibility of a price change in the physical commodity that the trader is planning to buy or sell. There are two types of hedges: a long hedge and a short hedge. A **short hedge** is the selling of a futures contract to protect the sale price of a commodity the trader is planning to sell. A **long hedge** is the buying of a futures contract to protect the purchase price of a commodity the trader is planning to buy. Most traders are able to liquidate or offset contracts prior to delivery. The long trader can offset a futures contract by subsequently purchasing a contract with the same delivery month. While most contracts entered into do not result in delivery, the threat of delivery still exists to serve the purpose of keeping the prices of futures contracts and their underlying cash market in reasonable alignment with one another. The **cash market** is where physical commodities are bought and sold.

When Should Traders Hedge?

In order to successfully hedge, producers must first determine what target price they need to cover cost of production to make a reasonable profit. Using cost of production figures and deciding a reasonable profit margin, producers can establish their target price range. The target price range should be viewed as a goal that may or may not be obtained during the crop year.

An Example of the Short Hedging Process

A producer decides to explore a variety of marketing alternatives, including futures, rather than settle for whatever the local elevator is willing to pay at harvest time. The producer's ultimate goal is to improve his or her bottom line. The producer estimates it will cost $2 to produce one bushel of corn. Once the producer sees corn prices in a range where a profit can be made, he or she decides to hedge a portion of the crop by selling 1 CBOT December corn futures contract. **The standard contract size for 1 CBOT corn futures contract equals 5,000 bushels.**

By early May, CBOT December futures are $2.60 a bushel. To lock in a selling price of $2.60, the producer sells 1 CBOT December corn futures contract. As it turns out, the Midwest experienced a bumper crop year. Corn yields were above normal, causing prices to drop. By harvest, corn prices fell to $1.90 a bushel. The producer offsets his/her futures position by purchasing 1 CBOT December corn futures contract. The result of the producer's hedging activities were:

CASH MARKET	FUTURES MARKET
May: Plan to sell 5,000 bushels of corn; sells 1 CBOT December corn	Sells 1 CBOT December corn futures contract @ $2.60/bu.
October: Sells 5,000 bushels of corn	Buys 1 CBOT December corn

in the cash market @ $1.90/bu	futures contract @ $1.90/bu
Sales price of corn	$1.90/bu
Plus futures gain ($2.60 - $1.90)	$0.70/bu
Net sale price	$2.60/bu

By using CBOT corn futures, the producer increased his or her final sales price from $1.90 to $2.60 a bushel. The producer accomplished his or her goal. Better yet, the final sale was one cent a bushel higher than his or her production expenses.

[illegible]

Back to top of page

Last Updated: [illegible]